

**BEFORE THE FEDERAL COMMUNICATIONS COMMISSION**

**WASHINGTON, D.C. 20554**

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|------------------------------|---|----------------------|
| In the Matter of             | ) |                      |
|                              | ) |                      |
| Preserving the Open Internet | ) | GN Docket No. 09-191 |
|                              | ) |                      |
| Broadband Industry Practices | ) | WC Docket No. 07-52  |
|                              | ) |                      |

**REPLY COMMENTS OF THE INSTITUTE FOR LIBERTY**

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April 26, 2010

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I. Introduction and Background

The Institute for Liberty (“IFL”) is pleased to submit the following Reply Comments in the above-named proceeding. By way of background, the Institute for Liberty is a non-profit 501(c)(4) membership-based advocacy organization which focuses on policy issues that affect small businesses and entrepreneurs in the United States. IFL believes that small businesses are the engine of the American economy, and that the federal government’s role is to promote, and not hinder, the creation and growth of these small businesses. For this reason, although we both commend Chairman Genachowski for his recognition of the importance of small businesses to the American Economy<sup>1</sup> and support the Commission’s efforts to promote a free and open Internet, it is clear that many of the comments filed in this proceeding advocate for onerous regulations that will harm small businesses in America. As shown below, the proposed non-discrimination rule will actually lead to (a) less broadband deployment, (b) higher prices for consumers and small business; (c) increased industry consolidation; and (d) the promotion of exclusionary conduct by broadband service providers, thus making it harder for small businesses to enter the applications market. In addition, given the D.C. Circuit’s holding in *Comcast v. FCC* and recent press reports indicating that the Commission may be considering reclassifying broadband as a Title II common carrier “telecommunications service”, we cannot refrain from pointing out that the Commission’s proposed “non-discrimination standard” abandons all nexus to established Title II caselaw (as well as the economic literature) and, as a result, is likely to create more harm than good. To this end, we respectfully submit that the Commission reject these calls for onerous government intervention, at least until the agency better understands why such regulation is needed and can reasonably predict the impacts of such interventions.

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<sup>1</sup> March 4, 2010 Remarks of Chairman Julius Genachowski, *Small Businesses and Broadband: Unlocking a Key Engine of Job Creation in the 21st Century*, DC Department of Small and Local Business Development, Washington, DC (available at: [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-296675A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296675A1.pdf)).

## II. Supporters of the FCC's Non-Discrimination Rule Provide No Evidence or Theory that Net Neutrality Will Not Deter Investment

As the Commission itself has acknowledged on numerous occasions and in this very proceeding, Congress clearly intended the Telecommunications Act of 1996 “to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.”<sup>2</sup> Section 706 of the 1996 Act also encourages the FCC to take actions that “remove barriers to infrastructure investment” so as to “encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans.” Naturally, as a result of these mandates, much of the discussion over net neutrality regulation turns to the effect of such regulatory interventions on the deployment of broadband Internet services to all Americans. At present, there is disagreement about the effect of net neutrality regulation on investment incentives without any resolution in sight.

### A. *The Literature Does Not Support Free Press's Assertion the Net Neutrality Will Increase Investment*

Free Press, for example, claims that “Network Neutrality will not deter ISP investment.”<sup>3</sup> However, Free Press provides not a shred of meaningful evidence to support this claim, while plenty exists to reject it. Numerous research efforts point to the investment curbing effects of Network Neutrality regulation. For example, a recent paper by Jan Kraemer and Lukas Wiewiorra of the Karlsruhe Institute of Technology in Germany shows that network discrimination “increases investments in transmission capacity and encourages innovation on the content provider side.”<sup>4</sup> Mark Jamison and Janice Hauge, both highly respected academics here in the U.S., find that as a consequence of optimal charges to content providers for prioritized delivery, a practice precluded by the FCC's proposed rule: (a) innovation is stimulated on the edges of the network; (b) smaller content providers benefit more than do larger content providers; and (c) the network provider increases its investment in network capacity when it offers premium transmission without degrading service for content providers that do not purchase the premium service; and (d) the number of network subscribers increases.<sup>5</sup>

The Phoenix Center for Advanced Legal and Economic Public Policy Studies also has published a number of papers on the threats of Network Neutrality regulation on investment, deployment and innovation. For example, in a refereed paper entitled *Network Neutrality and Foreclosing Market Exchange: Transaction Cost Analysis* published in the INTERNATIONAL JOURNAL OF MANAGEMENT AND NETWORK ECONOMICS, Beard et al. show that the very type of Network Neutrality regulation proposed by the Commission's NPRM results, under plausible conditions, in the following

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<sup>2</sup> Preamble, Telecommunications Act of 1996, P.L. 104-104, 100 Stat. 56 (1996); *In Re Preserving the Open Internet*, Notice of Proposed Rulemaking, FCC 09-93, 24 FCC Rcd. 13,064, 13,066 at n. 4 (2009)(hereinafter “*Open Internet NPRM*”).

<sup>3</sup> Free Press Comments at 3.

<sup>4</sup> J. Kraemer and L. Wiewiorra, *Network Neutrality and Congestion-Sensitive Content Providers: Implications for Service Innovation, Broadband Investment and Regulation* (March 15, 2010)(available at: <http://ssrn.com/abstract=1444423>).

<sup>5</sup> M. Jamison and J. Hauge, *Getting What You Pay for: Analyzing the Net Neutrality Debate* (April 20, 2008)(available at: <http://ssrn.com/abstract=1081690>).

outcomes: (a) consumers and small business would pay higher prices; (b) the profits of the broadband service provider would decline, likely reducing investment; (c) the sales of Internet content providers would decline, also likely reducing investment; and (d) sales will shift from content providers to the broadband provider's content affiliate.<sup>6</sup> All of these outcomes are contrary to the stated intent of Network Neutrality regulation, suggesting the proposed rules are plainly defective.

Another paper by Beard et al., *Network Neutrality and Industry Structure* published in HASTINGS COMMUNICATIONS AND ENTERTAINMENT LAW JOURNAL shows that the inherent commoditization of broadband service—an outcome intended by the Network Neutrality regulation proposed in the NPRM—may adversely impact market structure by eliminating competition.<sup>7</sup> This reduction in competition is likely to reduce aggregate investment spending, since fewer firms will be spending. Also, to the extent that competition increases investment incentives, as is claimed by The Free Press, this reduction in competition will reduce investment.

#### B. Net Neutrality Will Deter Rural Broadband Deployment

Moreover, Net Neutrality will likely have adverse consequences on network deployment in rural, high-cost markets, which are the very markets targeted by Section 706 and the National Broadband Plan. Reducing deployment in rural markets is certain to bring substantial harm to small business in those markets—businesses that are increasingly becoming dependent on communications technology to produce and sell their goods and services.

For example, in a paper entitled *The Burden of Network Neutrality Mandates on Rural Broadband Deployment*, Ford et al. find that “high-cost could be disproportionately affected by imposition of [Network Neutrality] mandates.”<sup>8</sup> Furthermore, using network cost models, the study reveals that Network Neutrality regulation reduces broadband deployment in all geographic areas but that the “differential reduction in service availability for high-cost rural areas is six times as much as in lower cost, more urbanized markets.” Raising the cost of network deployment while at the same time proposing to subsidize such deployment could be viewed as irresponsible policy making and contrary to the public interest.

In another paper entitled *Expanding the Digital Divide: Network Management Regulations and the Size of Providers*, Ford et al. show that limitations on network management practices, which have been proposed by Network Neutrality advocates, “are likely to affect disproportionately networks located in rural areas or smaller networks in urban markets given the cost disadvantages faced by such firms.”<sup>9</sup> The theoretical conclusion rests mainly on the unassailable assumption that network

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<sup>6</sup> T. R. Beard, G. S. Ford, T. M. Koutsky, and L. J. Spiwak *Network Neutrality and Foreclosing Market Exchange*, 1 INT. J. MANAGEMENT AND NETWORK ECONOMICS 160 (2009).

<sup>7</sup> T. R. Beard, G. S. Ford, T. M. Koutsky, and L. J. Spiwak, *Network Neutrality and Industry Structure*, 29 HASTINGS COMMUNICATIONS AND ENTERTAINMENT LAW JOURNAL 149 (2007).

<sup>8</sup> G.S. Ford, T. M. Koutsky, and L. J. Spiwak, PHOENIX CENTER POLICY PAPER NO. 25, *The Burden of Network Neutrality Mandates on Rural Broadband Deployment* (July 2006)(available at: <http://ssrn.com/abstract=925349>), and to be forthcoming in JOURNAL OF APPLIED ECONOMY.

<sup>9</sup> G. S. Ford, L.J. Spiwak and M.L. Stern, PHOENIX CENTER POLICY BULLETIN NO. 23, *Expanding the Digital Divide: Network Management Regulations and the Size of Providers* (October 1, 2009)(available at:

capacity is more costly in rural markets. Support for these conclusions by industry participants supports their validity, and there exist no meaningful challenge to the ideas contained in these works.<sup>10</sup>

*C. Net Neutrality Will Deter Wireless Broadband Investment*

Although Chairman Genachowski repeatedly states that he wants to make the United States a leader in mobile broadband,<sup>11</sup> theory and evidence support the notion that the application of Network Neutrality regulation to wireless carriers is likely to reduce efficient investment and innovation. Again, while numerous proponents of Net Neutrality argue that the Commission should apply its non-discrimination rule equally across platforms, no commenter has demonstrated that the benefits would outweigh the costs.<sup>12</sup> In fact, what evidence is available suggests applying Net Neutrality regulation to wireless networks is poor public policy. For example, Ford et al. used data from the 700 MHz auction to demonstrate that Network Neutrality could (a) suppress wireless infrastructure investment by \$50 billion over the next decade; (b) sharply reduce the profitability of wireless network services by 32%; (c) harm consumers; (d) limit consumer choice by creating more highly-concentrated market; and (e) cause particular harm to small or medium-sized wireless firms by enhancing the role of scale economies in determining industry structure.<sup>13</sup> Moreover, so-called “wireless *Carterfone*” obligations—or, in the parlance of the NPRM the “any device rule”<sup>14</sup>—are also likely to result in higher prices for consumers and small businesses.<sup>15</sup> There is no evidence that such regulatory obligations will increase the consumption of broadband services.

*D. Free Press’s Analysis Has Been Shown to be Patently Flawed*

The Free Press does make an effort at empirically supporting its investment claim.<sup>16</sup> However, the effort is feeble. Free Press argues that the positive change in AT&T’s total capital expenditures subsequent to its merger with SBC Communications is evidence that Network Neutrality increases investment. The causal linkage is laughable.

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<http://ssrn.com/abstract=1508491>). The relevance of this work is demonstrated in the Comments of Public Interest Commenters, wherein they claim “network management practices should never be used as a substitute for deployment of facilities and expansion of capacity (at 400).”

<sup>10</sup> See, e.g., Comments of Montana Telephone Association; Comments of ITTA at 15.

<sup>11</sup> February 24, 2010 Remarks of FCC Chairman Julius Genachowski, *Mobile Broadband: A 21st Century Plan for U.S. Competitiveness, Innovation and Job Creation*, New America Foundation Washington, DC (available at: [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-296490A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296490A1.pdf)).

<sup>12</sup> See, e.g., Comments of Skype Communications SARL at 5; Free Press Comments 121-126

<sup>13</sup> T. R. Beard, G. S. Ford, T. M. Koutsky, and L. J. Spiwak, PHOENIX CENTER POLICY BULLETIN NO. 20, *Using Auction Results to Forecast the Impact of Wireless Carterfone Regulation on Wireless Networks (Second Edition)* (May 2008)(available at: <http://ssrn.com/abstract=1126884>).

<sup>14</sup> See, e.g., *Open Internet NPRM*, *supra* n. 2 at ¶¶ 163-170.

<sup>15</sup> G.S. Ford, T.M. Koutsky, & L.J. Spiwak, *A Policy And Economic Exploration of Wireless Carterfone Regulation*, 25 SANTA CLARA COMPUTER & HIGH TECH. L.J. 647 (2009).

<sup>16</sup> Free Press Comments at 23-30. The same analysis appears in D. Turner, *Finding the Bottom Line: The Truth about Network Neutrality & Investment*, The Free Press (October, 2009) (available at: [http://www.freepress.net/files/Finding\\_the\\_Bottom\\_Line\\_The\\_Truth\\_About\\_NN\\_and\\_Investment\\_0.pdf](http://www.freepress.net/files/Finding_the_Bottom_Line_The_Truth_About_NN_and_Investment_0.pdf)).

Former FCC Chief Economist Professor Michael Katz assails the Free Press's claim by noting that they do not establish a plausible counterfactual to serve as a benchmark for measuring the effects of AT&T's commitments, which is the most fundamental requirement of empirical measurement. In doing so, Free Press study ignores several actors that clearly could affect AT&T's investment levels, including the merger itself as well as other commitments made by AT&T in seeking Commission approval. Moreover, Dr. Katz shows that the Free Press study ignores the facts that investments decisions are made with a lag and are driven by long-term considerations. As Dr. Katz explains:

An agreement reached in 2006 would not be expected to have its full impact in the following year. Even more important, AT&T would rationally anticipate that investments made in 2007 and 2008 would be free of the transitory commitments over most of the lives of the invested assets. Hence, AT&T's commitments would be expected to have relatively small impacts on the returns from AT&T's investments and would have a much smaller impact on investment levels than would permanent network neutrality rules.<sup>17</sup>

Dr. Katz also dismantles Free Press's assertion that network neutrality regulation would not harm investment incentives because Clearwire, Cellular South, and XO Communications support the network neutrality regulation and Clearwire is making significant investments without apparent concern that network neutrality will harm the return to its investment. As Dr. Katz further explains:

Far from supporting network neutrality regulation, however, these facts demonstrate that different companies have different business models and different assessments of the effects of network neutrality on the profitability of their business models. This variety of business models and approaches to various notions of "openness" is beneficial given the heterogeneity of consumer preferences and the high degree of uncertainty about future technological developments and the evolution of consumer demand. This is yet another reason why an attempt to force all broadband access providers into a single mold would distort competition and very likely harm consumers.<sup>18</sup>

In a thorough and compelling report, Phoenix Center Chief Economist Dr. George Ford also soundly sacks 'The Free Press' analysis.<sup>19</sup> Dr. Ford agrees that "[w]hile the effects of network neutrality regulations on the development of the Internet are worthy of careful consideration," the Free Press's analysis is "flimsy and self-serving," demonstrates a "lack of competence in empirical analysis," and "does not appear to even try to represent a serious analysis of the investment consequences of network neutrality regulation." The Free Press offers no meaningful replies to the criticisms levied by Dr. Ford (other than their typical juvenile *ad hominem* attacks), but others found

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<sup>17</sup> Testimony of Michael Katz at ft. 106, and at 59-61, in AT&T Comments.

<sup>18</sup> *Id.*

<sup>19</sup> G.S. Ford, PHOENIX CENTER PERSPECTIVE NO. 09-04, *Finding the Bottom: A Review of Free Press's Analysis of Network Neutrality and Investment* (October 29, 2009)(available at: <http://ssrn.com/abstract=1497427>).



his arguments compelling.<sup>20</sup> Clearly, the Free Press's investment arguments have zero probative value.

But perhaps the best critique of Free Press's logic comes from none other than Google. While Google claims that Internet regulation will spur investment and innovation, its own Comments reject its position. Specifically, Google claims that firms "will not make steep economic investments without assurances [of] their likelihood of achieving commercial success."<sup>21</sup> Google then claims that Network Neutrality regulation is intended to impede "the commercial designs of broadband network providers."<sup>22</sup> By Google's own logic, Network Neutrality impedes steep "economic investments" by impeding "commercial success." Moreover, Google claims that a "commercial marketplace free from regulation allows entrepreneurs and innovators to focus on developing new online services, content and applications."<sup>23</sup> Since the Commission's proposed non-discrimination rule is unambiguously price regulation,<sup>24</sup> and is "heavy handed" price regulation at that,<sup>25</sup> Google's Comments argue for less regulation of the Internet. Yet, in direct contrast to its own reasoning, Google claims that Network Neutrality will stimulate rather than deter investment. As in the case of Free Press, Google provides no evidence, either of a theoretical or empirical nature, to support the claim that Network Neutrality increases investment or innovation.

### **III. Supporters of the FCC's Rule Provide No Compelling Evidence or Theory that Net Neutrality Will Not Result in Higher Prices**

An issue avoided by the proponents of Network Neutrality regulation is the effect of such interventions on consumer prices. While proponents sometimes claim Network Neutrality is a pro-consumer intervention (while others, like Google, more honestly recognize Network Neutrality as a boon to their business), the regulation is likely to result in higher prices and less network deployment. Give that every dollar is precious to small businesses, policies that result in high prices for broadband are, by definition, counterproductive and detrimental to American entrepreneurship.

The FCC's proposal in its NPRM appears to limit the ability of broadband providers to set positive prices to content providers under any circumstances. By the nature of two-sided markets, prohibiting prices to content providers thereby forcing all costs and profits to be recovered directly from consumers, thereby keeping consumer prices higher.<sup>26</sup> In other words, a positive price to content providers encourages lower prices to consumers since the profit from content providers depends on the size of the customer base. Shifting some revenues to content providers may spur

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<sup>20</sup> Katz, *supra* n. 17.

<sup>21</sup> Google Comments at 12.

<sup>22</sup> *Id.* at 13.

<sup>23</sup> *Id.* at 86.

<sup>24</sup> G.S. Ford and M.L. Stern, PHOENIX CENTER PERSPECTIVE NO. 10-02, *Sabotaging Content Competition: Do Proposed Net Neutrality Regulations Promote Exclusion?* (March 4, 2010)(available at: <http://ssrn.com/abstract=1576565>).

<sup>25</sup> Free Press Comments at 27 ("Some regulation is heavy-handed, designed to control retail prices").

<sup>26</sup> In the theory of two-sided markets, raising price on one side of the market results in lower prices on the other side of the market. Jean-Charles Rochet and Jean Tirole, *Platform Competition in Two-Sided Markets*, JOURNAL OF THE EUROPEAN ECONOMIC ASSOCIATION, 2003, 1 (4), 990{1029.

broadband adoption through lower prices, an outcome likely in the public interest. However, this desirable outcome is precluded by the FCC's proposal.

Economics suggests that the FCC should not be in the business of price regulating this two-sided market. In a recent paper by E. Glen Weyl, the author concludes that regulators should not focus on the "balance" of prices—that is, the price charged to one side or the other of the two-sided market—but should instead focus solely on the overall price level (the sum of the two prices) as a measure of market performance. Specifically, the author recommends "[r]educing the price level rather than changing its balance should be the aim of policy."<sup>27</sup> This result differs somewhat from that of Nicolas Economides and Joacim Tag, who do contend that the balance matters.<sup>28</sup> However, Dr. Weyl's paper shows that the Economides-Tag result is unique to their linear specification. Furthermore, Economides-Tag exaggerate their findings. Their analysis shows that the effects of regulation may be positive or negative, and are negative only if " $a < 5b$  and  $ft$  is sufficiently large."<sup>29</sup> Has the Commission determined that these conditions are plausibly satisfied? Without question, the findings in Economides-Tag are ambiguous on the welfare effects of Net Neutrality regulation, despite the slanted conclusions drawn by the authors.<sup>30</sup>

Similarly, Ford et al. demonstrate that the cost of providing a residential subscriber a "stupid" network, a moniker for the "Net Neutral" network, could be \$300 more per month than a managed network with more limited capacity.<sup>31</sup> Such high prices would certainly price broadband above a level affordable by most Americans. This sizeable price increase is supported by a peer-reviewed study published by Richard Clarke in the *Review of Network Economics*.<sup>32</sup> Moreover, as mentioned above, Beard et al. show how prohibiting voluntary contracts between broadband providers and content firms—the exact intent of the FCC's proposal—can lead to higher prices for consumers for broadband services.<sup>33</sup>

Put simply, there is a good chance that Network Neutrality regulation puts upward pressure on prices. Economic theory and empirical work indicates that such regulation will likely raise prices. In contrast, there is not a shred of evidence to suggest that Network Neutrality regulation will lower prices for consumers. Network Neutrality, consequently, must be expected to raise broadband prices, thereby reducing adoption. In this regard, Network Neutrality regulation is not in the public interest and certainly harmful to price conscious small businesses and entrepreneurs.

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<sup>27</sup> G.E. Weyl, *The Price Theory of Two-Sided Markets* (March 13, 2009)(available at: <http://ssrn.com/abstract=1324317>) at 26.

<sup>28</sup> N. Economides and Joacim Tag, *Net-Neutrality on the Internet: A Two-Sided Markets Approach*, (2007)(available at: <http://www.stern.nyu.edu/networks/cvnoref.html>).

<sup>29</sup> *Id.* at 17.

<sup>30</sup> For the valid parameter set ( $a = 2$ ,  $b = 1$ ,  $f = 2$ ,  $t = 2$ ,  $v = 2$ ,  $c = 1$ ; satisfying all conditions on pp. 9-10 of Economides-Tag), Equation (41) in Economides-Tag confirms that "removing net neutrality regulation" increases total surplus (i.e.,  $\Delta TS > 0$ ). *Id.*

<sup>31</sup> G.S. Ford, T.M. Koutsy, and L.J. Spiwak, PHOENIX CENTER POLICY BULLETIN NO. 16, *The Efficiency Risk of Network Neutrality Rules* (May 2006)(available at: <http://ssrn.com/abstract=925347>).

<sup>32</sup> R.N. Clarke, *Costs of Neutral/Unmanaged IP Networks*, REVIEW OF NETWORK ECONOMICS: Vol. 8, 61-89 (2009).

<sup>33</sup> *Supra* n. 6.



#### IV. Supporters of the FCC Rule Provide No Compelling Evidence or Theory that Net Neutrality Will Result in More Competition or Prevent Firms from Engaging in Exclusionary Conduct

Proponents of Network Neutrality regulation appear to believe that government intervention is required to impede broadband service providers from engaging in anti-competitive conduct, which apparently is defined exceedingly broadly to include all “commercial designs” of broadband service providers.<sup>34</sup> For example, both Google<sup>35</sup> and Free Press<sup>36</sup> (as well as the Commission itself<sup>37</sup>) cite to the work of Barbara Van Schewick, who asserts “absent network neutrality regulation, network providers will likely discriminate against or exclude independent producers of applications, content, or portals from their networks.”<sup>38</sup> More recently, Chettiar and Holladay (2010) opine that “[w]ithout net neutrality, new technologies could lead to pricing practices that transfer wealth from content providers to ISPs.”<sup>39</sup>

Due to the (apparent) lack of understanding of basic economics, Professor Schewick—and by extension the Commission itself—actually have it precisely *backwards*. Once the economics are correctly understood, *the rule the Commission seeks to impose will not impede exclusionary conduct, it will promote it*. As explained by Ford and Stern, the “the proposed net neutrality rules of both the FCC and Congress ... actually promote [] exclusionary behavior,” and “the incentive to monopolize is greater under net neutrality.”<sup>40</sup> This is because Network Neutrality, in the form of price regulation on broadband service providers, increases the return from exclusionary conduct by prohibiting more market-friendly methods to extract surplus (i.e., price). If a proposed rule increases the incentive to do the very thing the rule is intended to impede, then it is abundantly clear the FCC has not carefully designed its Network Neutrality policies. Clearly, such an outcome does not help the small entrepreneur in his or her garage seeking to develop the next “killer app.”

#### V. Supporters of the FCC Rule Provide No Compelling Evidence or Theory that Net Neutrality is Required because of a Lack of Competition in Broadband Markets

The standard measure of a lack of competition is high profits. The Free Press claims that “major phone and cable companies are currently earning record profits.”<sup>41</sup> As is typical, the Free

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<sup>34</sup> Google Comments at 13.

<sup>35</sup> *Id.* at 34.

<sup>36</sup> Free Press Comments at 72.

<sup>37</sup> *Open Internet NPRM*, *supra* n. 2 at n. 146.

<sup>38</sup> B. Van Schewick, *Towards and Economic Framework for Network Neutrality Regulation*, 5 JOURNAL ON TELECOMMUNICATIONS AND HIGH TECHNOLOGY LAW 329-392 (2007), at 239. Van Schewick’s analysis never states what restrictions are imposed on the BSP in a network neutrality scheme and never defines the objective function of the BSP, so this statement is merely assertion.

<sup>39</sup> I. Chettiar and J. Holladay, *Free to Invest: The Economic Benefits of Preserving Net Neutrality*, Institute for Policy Integrity, New York University School of Law, Report No. 4 (January 2010) at viii (available at: [http://www.policyintegrity.org/documents/Free\\_to\\_Invest.pdf](http://www.policyintegrity.org/documents/Free_to_Invest.pdf)).

<sup>40</sup> G.S. Ford and M.L. Stern, PHOENIX CENTER PERSPECTIVES NO. 10-02, *Sabotaging Content Competition: Do Proposed Net Neutrality Regulations Promote Exclusion?* (March 4, 2010)(available at: <http://ssrn.com/abstract=1576565>).

<sup>41</sup> Free Press Comments at 67-68; 70.

Press provides no evidence to support the statement and, if the data is actually evaluated, the organization is once again proven to be incorrect.<sup>42</sup>

The profitability of firms in the Internet ecosystem was evaluated carefully by Ford and Spiwak.<sup>43</sup> In Table 1, three of most widely-used financial profitability indexes are provided for BSPs —AT&T, Verizon, Sprint-Nextel, Qwest, Comcast, Time Warner Cable—and content providers such as Google and EBay. Averages for the S&P 500 are listed for comparison purposes. There are a number of important facts indicated by this table. First, the profitability of broadband service providers are well below those of the average firm on the S&P 500 and consistently so. In contrast, Google's and EBay's profitability are consistently above, and well above, the average profitability of S&P 500 firms. So it is content, not broadband service providers, which appear to be earning supernormal profits.

**Table 1. Profitability Measures of Internet Firms**

|                                     | AT&T   | Verizon | Qwest | Sprint-<br>Nextel | Comcast | Time<br>Warner<br>Cable | S&P 500<br>Average |
|-------------------------------------|--------|---------|-------|-------------------|---------|-------------------------|--------------------|
| <i>Net Profit Margin (%) (2009)</i> | 10.4   | 9.6     | -7.6  | 5.4               | 10.2    | 6.1                     | 10.2               |
| 5-Year Average                      | 10.6   | 9.9     | -18.5 | 6.0               | 8.0     | -5.0                    | 12.2               |
| <i>Return on Equity (%) (2009)</i>  | 12.7   | 8.8     | -12.8 | ...               | 8.8     | 8.3                     | 13.5               |
| 5-Year Average                      | 10.9   | 12.3    | -20.2 | ...               | 5.8     | -3.0                    | 9.9                |
| <i>Return on Assets (%) (2009)</i>  | 4.8    | 4.8     | -4.3  | 3.3               | 3.2     | 2.4                     | 5.0                |
| 5-Year Average                      | 4.4    | 4.8     | -8.9  | 3.3               | 2.2     | -1.4                    | 4.5                |
|                                     | Google | Ebay    |       |                   |         |                         |                    |
| <i>Net Profit Margin (%) (2009)</i> | 28.3   | 27.4    |       |                   |         |                         |                    |
| 5-Year Average                      | 24.7   | 19.0    |       |                   |         |                         |                    |
| <i>Return on Equity (%) (2009)</i>  | 20.7   | 19.2    |       |                   |         |                         |                    |
| 5-Year Average                      | 20.1   | 12.5    |       |                   |         |                         |                    |
| <i>Return on Assets (%) (2009)</i>  | 18.5   | 14.1    |       |                   |         |                         |                    |
| 5-Year Average                      | 18.1   | 9.7     |       |                   |         |                         |                    |

Second, the profitability of the broadband service providers is not at record levels. Broadband service providers' recent profits are generally comparable to their 5-year averages, indicating stable and not "record" profitability. Once actual (publicly available) profitability data is considered, it obvious that broadband firms are not particularly profitable firms are not experiencing "record" or "soaring" profits as claimed by the Free Press.

<sup>42</sup> See, e.g., Ford, *Finding the Bottom*, *supra* n. 19. See also George Ou's posts at <http://www.digitalsociety.com>, including *Free Press Net Neutrality Proposals Would Devastate Economy* (March 3, 2010); *Free Press Wants the FCC to Mandate a Dumb Internet* (March 17, 2010); *We can't Pretend Wireless and Wired Networks are the Same* (March 26, 2010); and K. Daniel Glover's, *Sprinting to False Conclusions* (March 30, 2010) (available at: <http://www.digitalsociety.com>).

<sup>43</sup> G.S. Ford and L.J. Spiwak, PHOENIX CENTER PERSPECTIVE NO 10-04, *Substantial Profits in the Broadband Ecosystem: A Look at the Evidence* (April 22, 2010)(available at: <http://ssrn.com/abstract=1596255>).

## VI. The Commission's Proposed Non-Discrimination Rule Lacks a Firm Legal Footing

As we all know, the D.C. Circuit just ruled against the Commission in *Comcast v. FCC*. However, even if the Commission were to reclassify broadband services as a Title II common carrier service—something which we believe would be the wrong policy option to take—reclassification still does not get the Commission to where it wants to go. In the Commission's NPRM, the Commission deliberately rejects the “undue discrimination” standard of Section 202 of the Communications Act. Instead, the Commission creates a new standard of nondiscrimination by citing to the “unqualified prohibitions added to Title II in the 1996 Telecommunications Act”;<sup>44</sup> specifically, the interconnection provisions contained in Section 251(c)(2)(D) that require incumbent local exchange carriers to provide “interconnection” to their networks “on rates, terms, and conditions that are just, reasonable, and nondiscriminatory.”<sup>45</sup> Under the FCC's proposed new definition, “non-discrimination” means that “... that a broadband Internet access service provider may not charge a content, application, or service provider for enhanced or prioritized access to the subscribers of the broadband Internet access service provider.”<sup>46</sup>

Several commenters support the FCC's legal gamesmanship. For example, Free Press vigorously supports this interpretation, arguing that the undue discrimination standard under Section 202 is, for example, “ineffective and toothless”<sup>47</sup>, “vague and arbitrary”<sup>48</sup>, “utterly unworkable”<sup>49</sup> and, most egregiously, having “no clear standards on which a reviewing court could hang a reversal.”<sup>50</sup> Similarly, Google, the corporation who stands to benefit most from the Commission's actions in this docket, argues that “Adopting an ‘unjust and unreasonable discrimination’ standard and reasonable network management exception would establish a more murky, complex, and likely ineffectual legal standard.”<sup>51</sup> Apparently, neither counsel for Free Press or Google have checked the case law.

According to well-established jurisprudence, a charge that a carrier has unduly discriminated in violation of Section 202 entails a three-step inquiry (in the sequence): (1) whether the services are “like”; (2) if they are “like,” whether there is a price difference; and (3) if there is a difference, whether it is reasonable.<sup>52</sup> If the services are not “like,” or not “functionally equivalent” in the legal parlance, then discrimination is not an issue and the investigation ends. There is no discrimination claim for *different* prices or price-cost ratios for *different* goods. Notably, a determination of whether services are “like” is based upon neither cost differences nor competitive necessity. Cost differentials are excluded from the likeness determination and introduced only to determine “whether the discrimination is unreasonable or unjust.” Likeness is based solely on functional

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<sup>44</sup> *Open Internet NPRM*, *supra* n. 2 at ¶ 109.

<sup>45</sup> 47 U.S.C. § 251(c)(2)(D).

<sup>46</sup> *Open Internet NPRM*, *supra* n. 2 at ¶ 106.

<sup>47</sup> Free Press Comments at 79

<sup>48</sup> *Id.* at p 80.

<sup>49</sup> Free Press February 19, 2010 *ex parte* and attachments thereto.

<sup>50</sup> *Id.*

<sup>51</sup> Google Comments at 62.

<sup>52</sup> *See, e.g., MCI Telecommunications Corp. v. FCC*, 917 F.2d 30, 39 (D.C. Cir. 1990) and citations therein.

equivalence.<sup>53</sup> If the services are determined to be “like” or “functionally equivalent,” then the carrier offering them has the burden of justifying any price disparity as reasonable, such as a difference in cost.<sup>54</sup> If a price difference is not justified, then the price difference is deemed unlawful. Thus, for Free Press and Google to argue that the “undue discrimination” standard under Section 202 is devoid of meaning and unenforceable reveals a patent lack of institutional knowledge of this business.

Equally as important, the FCC’s proposal is plainly inconsistent with standard legal and economic definitions of discrimination. As Ford and Spiwak explain,

the FCC’s proposed rule states that BSPs “may not charge a content ... provider for enhanced or prioritized access.” However, standard services and enhanced/prioritized services are, by definition, not functionally equivalent and thus not “like,” so a different price for these different services is certainly not discrimination under communications law (as set forth in Section 202). If a higher price for enhanced services was reviewed under standard procedure, then the question of discrimination does not proceed beyond the first stage of legal review. Since the services are not “like,” the investigation ends. Economics likewise requires the goods to be “identical,” so different prices for standard service versus enhanced or prioritized services is not discriminatory under the economic standard. It is obvious, therefore, that the FCC has defined a set of “discriminatory” prices that would not qualify as such under meaningful legal and economic definitions of discrimination. Labeling as “discrimination” different prices for different goods is a fundamental defect in the Commission’s approach.<sup>55</sup>

Moreover, citing to Section 251 is of no help to either the Commission or its supporters. As Ford and Spiwak explain, “charging different prices for different things is in no sense discrimination, whether evaluated using the logic of economics, Section 202, or Section 251. An unbundled switch port does not have the same price as an unbundled loop, and a DS1 does not have the same price as a DS3.”<sup>56</sup> Moreover, under the plain terms of the Commission’s original *Section 251 Order*, the FCC expressly permitted the very type of arrangement that would now be expressly precluded by the agency’s proposed non-discrimination rule. Specifically, the *Section 251 Order* allows differences in the quality of interconnection, stating that non-discrimination,

... does not excuse incumbent LECs from providing, when requested and where technically feasible, access or unbundled elements of *higher* quality (emphasis added).<sup>57</sup>

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<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> G.S. Ford and L.J. Spiwak, PHOENIX CENTER PERSPECTIVE NO. 10-03, *Non-Discrimination or Just Non-Sense: A Law and Economics Review of the FCC’s New Net Neutrality Principle* (March 24, 2010)(available at: <http://ssrn.com/abstract=1580133>).

<sup>56</sup> *Id.*

<sup>57</sup> *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15,499, FCC 96-325, FIRST REPORT AND ORDER (August 8, 1996) at ¶ 313.

In addition, the FCC permits payments for this higher quality, observing

... the 1996 Act requires a requesting carrier to pay the costs of unbundling, and thus incumbent LECs will be fully compensated for any efforts they make to increase the quality of access or elements within their own network.<sup>58</sup>

Thus, the *Section 251 Order* permits, if not mandates, a “charge for enhanced access.” The FCC’s insistence that discrimination under Section 251(c)(2) prohibits charges for different qualities is, as Ford and Spiwak observe, entirely at odds with its own implementation of that portion of the statute in a case where the statute was directly applicable (unlike the present case). Accordingly, even if the Commission were to reclassify broadband services as a Title II common carrier service—something which we hope the Commission will not do—its reinvented notion of non-discrimination far exceeds any conceivable and justifiable concept of Title II jurisprudence.

## VII. Conclusion

As Chairman Genachowski recently recognized, “small and medium businesses have created over 64 percent of all net new jobs—more than 14 million—over the past 15 years.”<sup>59</sup> If the Chairman is to be taken at his word, however, then why is the Commission so insistent to promulgate a rule that by all competent analysis will likely cause prices to rise and deployment to be reduced for the very sector he seeks to promote? For these reasons, IFL therefore respectfully asks the Commission to reject claims to impose onerous “open Internet” regulations and to start with a clean slate to promulgate rules where the costs will not outweigh the perceived benefits.

IFL proposes that the Commission ask itself three questions not contemplated in its NPRM. First, will the Commission know more about the evolution of the Internet and the behaviors of its participants five years in the future than it does today? The answer is obviously yes. Second, if the Commission does not codify new rules on Network Neutrality, should we expect significant anti-competitive harm to occur in the next five years? The answer is in all probability “No.” As even the most staunch neutrality regulation advocates admit, there is “de facto” net neutrality today and ISPs are not engaging in systematic acts of non-neutrality.<sup>60</sup> Third, if knowledge is gained by waiting, and no harm is caused by waiting, then what motivates the Commission to act now?

If the Internet is as beneficial as people seem to believe, then the treatment of it by the Federal Government should rise above political expediency. We shall see whether that is true as a result of this proceeding.

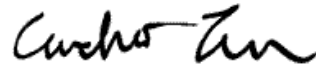
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<sup>58</sup> *Id.*

<sup>59</sup> *See supra* n. 1.

<sup>60</sup> Chettiar and Holladay, *supra* n. 39.

Respectfully submitted:



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